

Internal Revenue Service

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Date: SEPTEMBER 06, 2005

Legend

- Settlor -
- Child A -
- Grandchild 1 -
- Grandchild 2 -
- Trustees -
- Trust -

- Trust A -

- Trust B -

- Date 1 -
- Date 2 -
- Date 3 -
- State X -
- State X Statue -

Dear :

This is in response to a letter dated December 23, 2004, on behalf of Trustees, Child A, Grandchild 1 and Grandchild 2 requesting rulings concerning the estate and gift tax and generation-skipping transfer (“GST”) tax consequences of the distribution from a trust created for the benefit of Child A and Child A's issue, as described below.

Facts

On Date 1, prior to September 25, 1985, Settlor established Trust, an irrevocable charitable lead trust, governed under the law of State X. Under the terms of Trust, an annuity is to be paid to charitable organizations selected by the trustee for a 20 year term. At the expiration of that term, the corpus is to be divided into equal shares, per capita, for each child, grandchild, and more remote issue of Settlor who was then living. Each share is to be distributed outright to that child, grandchild, and more remote issue. However, if a beneficiary is less than 35 years of age, that beneficiary's share is to be held in a separate trust for his or her benefit. Under the terms of each separate trust, the trustee has the discretion to accumulate the net income and add it to principal, or distribute it in convenient installments, but not less often than annually, to or for the benefit of the beneficiary or that beneficiary's issue. The trustee is also authorized ". . . at any time or from time to time, to pay to or apply for the benefit of any one or more or all of the Beneficiary and such issue such part or all of the principal of the trust, and in such proportions, as the Trustees shall deem advisable in their absolute discretion for any reason whatsoever, even though any such payment or payments shall result in the termination of the trust." The remaining principal of the beneficiary's trust will be distributed to that beneficiary upon the beneficiary attaining age 35. In the event that the beneficiary dies before reaching age 35, the principal will be distributed, per stirpes, in equal shares to that beneficiary's issue or, if none, in equal shares to the issue, per stirpes, of a parent or more remote ancestor of the beneficiary, or, if none, to the living issue of the Settlor. Further, any distribution to an issue or other distributee of the Settlor for whom a trust is already in existence, will be added to that trust and any distribution to a beneficiary under age 35 will be held in further trust for the benefit of that beneficiary. If there is no living issue or other beneficiary, the principal will be distributed to one or more charitable organizations selected by the trustees.

Under the terms of Trust, Trust and any trust created under its terms must terminate no later than 21 years after the death of the last survivor of all the issue of Settlor's parents and the issue of a specific individual who were living on Date 1, when Trust was created.

Trust terminated on the expiration of the 20 year term on Date 2. At that time, in accordance with the Trust instrument, Trust was divided into equal shares for the Settlor's children, grandchildren, and more remote issue. One such beneficiary, Child A, had not attain age 35 on Date 2. Accordingly, under the terms of Trust, his share was held in further trust (Trust A) under the terms described above. The trustees of Trust A are unrelated to Child A and Child A's issue. As noted above, when Child A reaches age 35, the principal of Trust A is to be distributed to Child A.

The trustees of Trust A (Trustees) executed Trust B on Date 3 for the benefit of Child A and his issue. The trustees pursuant to their distributive power under Trust A,

as described above, propose to distribute the principal of Trust A to Trust B. Trustees are the trustees of Trust B.

Under the terms of Trust B, the net income will be paid or applied to the benefit of any one or more of Child A and his children, no less often than annually. However, the trustees may, in their discretion, add any or all of the net income to principal. In addition, the trustees may, in their absolute discretion, distribute any or all of the principal to or for the benefit of one or more of Child A and his children at any time for any reason. The trustees have the powers granted to trustees under the laws of State X and, at all times, at least one-half of the trustees must be independent trustees. Trust B also provides that no beneficiary who is acting as a trustee shall exercise or participate in the exercise of any of the discretionary powers of the trustees to distribute income or principal to himself or herself and no trustee shall pay or apply the income or principal of the trust for his or her own pecuniary benefit or the discharge of his or her legal obligations. The provisions of Trust B will be governed by the laws of State X.

On Child A's death, the Trust B corpus will be distributed in accordance with Child A's exercise of a limited testamentary power to appoint the trust principal among his living children and/or the estate of any deceased child. The exercise of any power of appointment over the assets of Trust B will not be effective unless the property subject to the exercise is (i) paid outright to an individual or (ii) paid to one or more trusts for the benefit of an individual that terminates before that individual's death or is included in that individual's gross estate. Any exercise of the power may be made for the benefit of any one or more permissible appointees and, as to any appointee, upon any present, future, vested, or contingent estate, outright or in trust. In default of Child A's exercise of the power, the principal will be divided into shares, one for each living child of Child A and one for each deceased child who is survived by living issue. The shares will be distributed to the living children and to the estate of any deceased child. If there are no living issue of Child A, the principal will be paid to any of Settlor's living issue who is in the "generational group," defined as Settlor's issue who are in a higher or same generation (defined under IRC § 2651) as Child A's children. Otherwise, the principal will be distributed to one or more charitable organizations selected by the trustees.

Any trust created pursuant to the terms of Trust B, including any trust created pursuant to Child A's exercise of his power of appointment, must terminate in all events no later than the termination date set forth under Trust.

In addition, the administrative provisions of Trust B will be modified so that the powers of the trustees will be limited to powers granted to trustees under the laws of State X, resulting in a limitation, rather than an expansion, of the trustee powers.

State X Statute provides:

A trustee who has the absolute discretion, under the terms of a testamentary instrument or irrevocable inter vivos trust agreement, to invade the principal of a trust for the benefit of one or more proper objects of the exercise of the power, may exercise such discretion by appointing all or part of the principal of the trust in favor of a trustee of a trust under an instrument other than that under which the power to invade is created or under the same instrument, provided however, that the exercise of discretion (A) does not reduce any fixed interest of any income beneficiary of the trust, (B) is in favor of the proper objects of the exercise of the power, and (C) does not violate the limitations of [State X statute addressing limitations on powers and immunities of executors and testamentary trustees not applicable in this case]...

You represent that there have been no additions to Trust or Trust A after September 25, 1985.

The trustees have requested the following rulings:

1. The distribution will not subject distributions from Trust A or Trust B to the generation-skipping transfer tax;
2. The distribution to Trust B will not constitute a gift by Child A or his children that is subject to federal gift tax;
3. The distribution to Trust B will not subject the assets of Trust B to inclusion in the gross estate of Child A or the gross estate of any his children for federal estate tax purposes; and
4. The distribution will not cause any person to be treated as the owner of any portion of Trust B for federal income tax purposes under IRC §§ 671 – 679.

Law and Analysis

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST). Section 1433(b)(2)(A) of the Tax Reform Act of 1986 (the Act), 1986-3 (Vol. 1) C.B. 1, and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, provide that the generation-skipping transfer tax does not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer was not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(1)(iv) provides that if an addition is made after September 25, 1985, to an irrevocable trust which is excluded from chapter 13 by reason of

§ 26.2601-1(b)(1), a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13.

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b)(1), (b)(2), or (b)(3), will not cause the trust to lose its exempt status. Unless specifically provided otherwise, the rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for generation-skipping transfer tax purposes. Thus, these rules generally do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(A) provides that the distribution of trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to the GST provisions, if – (1) either (i) the terms of the governing instrument of the exempt trust authorize distribution to a new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and (2) the terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation.

Section 26.2601-1(b)(4)(i)(E), Example 1, provides that:

In 1980, Grantor established an irrevocable trust (Trust) for the benefit of Grantor's child, A, A's spouse, and A's issue. At the time Trust was established, A had two children, B and C. A corporate fiduciary was designated as trustee. Under the terms of Trust, the trustee has the discretion to distribute all or part of the trust income to one or more of the group consisting of A, A's spouse or A's issue. The trustee is also authorized to distribute all or part of the trust principal to one or more trusts for the benefit of A, A's spouse, or A's issue under terms specified by the trustee in the trustee's discretion. Any trust established under Trust, however, must terminate 21 years after the death of the last child of A to die who was alive at the time Trust was executed. Trust will terminate on the death of A, at which time the remaining principal will be distributed to A's issue, per stirpes. In 2002, the trustee distributes part of Trust's principal to a new trust for the benefit of B and C and their issue.

The new trust will terminate 21 years after the death of the survivor of B and C, at which time the trust principal will be distributed to the issue of B and C, per stirpes. The terms of the governing instrument of Trust authorize the trustee to make the distribution to a new trust without the consent or approval of any beneficiary or court. In addition, the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest in a manner that may postpone or suspend the vesting, absolute ownership or power of alienation of an interest in property for a period, measured from the date of creation of Trust, extending beyond any life in being at the date of creation of Trust plus a period of 21 years, plus if necessary, a reasonable period of gestation. Therefore, neither Trust nor the new trust will be subject to the provisions of [the GST tax].

Trust, pursuant to which Trust A was established, was irrevocable on Date 1, which was before September 25, 1985. Further, it has been represented that there have been no additions made to Trust or Trust A after September 25, 1985. Accordingly, Trust A is currently exempt from the GST tax under § 26.2601-1(b)(1).

Under the terms of Trust A, the trustees are authorized “to pay to or apply for the benefit of” any one or more or all of Child A and Child A’s issue, such part or all of the trust principal, “in their absolute discretion for any reason whatsoever, even though any such payment or payments shall result in the termination of the trust.” In addition, the terms of Trust B incorporate the same rule against perpetuities provision contained in Trust, that applies to Trust A, and therefore, do not extend the time for vesting of any beneficial interest beyond the period provided for under Trust A. Accordingly, we conclude that the trustee’s exercise of the power to distribute the income and principal of Trust A to Trust B will not cause distributions from Trust A or Trust B to be subject to the GST tax provisions under § 2601. See §§ 26.2601-1(b)(4)(i)(A)(1)(i) and (A)(2). Further, the modifications to the administrative provisions contained in Trust B, will not cause distributions from Trust A or Trust B to be subject to the GST tax provisions under § 2601.

Ruling 2

Section 2501(a) imposes a gift tax for each calendar year on the transfer of property by gift during the year by an individual.

Section 2511 provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift.

Section 25.2511-1(g)(1) of the Gift Tax Regulations provides that donative intent on the part of the transferor is not an essential element of the gift tax and that the application of the gift tax is based on the objective facts of the transfer and the circumstances under which it is made, rather than the subjective motives of the donor. However, there are certain types of transfers to which the tax is not applicable. It is applicable only to a transfer of a beneficial interest in property and not applicable to a transfer of bare legal title to a trustee. A transfer by a trustee of trust property in which the trustee has no beneficial interest does not constitute a gift by the trustee (but such a transfer may constitute a gift by the creator of the trust, if until the transfer the creator had the power to change the beneficiaries by amending or revoking the trust).

In this case, Settlor had established Trust, which was irrevocable, and had not retained the right to alter or amend Trust. Likewise, Trust A, created for the benefit of Child A pursuant to the terms of Trust, was irrevocable and could not be altered or amended by Settlor, Child A, or any issue of Child A. The assets of Trust A will be distributed to Trust B by the trustees, who have no beneficial interest in Trust A, pursuant to their discretionary authority under the terms of Trust A and State X Statute. Accordingly, based on the facts submitted and representations made, we conclude that the distribution by the trustees of the principal of Trust A to Trust B will not constitute a gift by Child A, Grandchild 1, or Grandchild 2 that is subject to federal gift tax.

Ruling 3

Section 2031(a) provides that the value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2036(a) provides that the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in a case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period that does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Section 20.2036-1(b)(3) of the Estate Tax Regulations provides that the phrase "right . . . to designate the person or persons who shall possess or enjoy the transferred property or the income therefrom" includes a reserved power to designate the person or persons to receive the income from the transferred property, during the decedent's life

or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death. With respect to such a power, it is immaterial (i) whether the power was exercisable alone or only in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's lifetime). The phrase, however, does not include a power over the transferred property itself which does not affect the enjoyment of the income received or earned during the decedent's life. Nor does the phrase apply to a power held solely by a person other than the decedent. But, for example, if the decedent reserved the unrestricted power to remove or discharge a trustee at any time and appoint himself as trustee, the decedent is considered as having the powers of the trustee.

Section 20.2036-1(b)(2) provides that the term "use, possession, right to the income, or other enjoyment of the transferred property" is considered to have been retained by or reserved to the decedent to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent, or otherwise for his pecuniary benefit.

Section 2038(a)(1) provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate the interest in the property or where the decedent relinquished such power within the three-year period ending on the date of the decedent's death.

Section 2041(a)(2) provides that the value of the gross estate shall include the value of all property to the extent of any property with respect to which the decedent has at the time of his death a general power of appointment created after October 21, 1942, or with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under §§ 2035 to 2038, inclusive. Section 2041(b)(1) defines a general power of appointment as a power that is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate.

As noted above, the trustees, who have no beneficial interest in Trust A, propose to distribute the assets of Trust A to Trust B pursuant to their discretionary authority under the terms of Trust A and State X Statute. Further, as described above, at least one-half of the trustees must be independent trustees and no beneficiary who is acting as a trustee shall exercise or participate in the exercise of any of the discretionary

powers of the trustees to distribute income or principal to himself or herself. Also, no trustee shall pay or apply the income or principal of the trust for his or her own pecuniary benefit or the discharge of his or her legal obligations. Accordingly, we conclude that the assets held in Trust B will not be included in the gross estate of Child A, or the gross estate of Grandchild 1 or Grandchild 2, under §§ 2036 or 2038. See, Rev. Rul. 54-153, 1954-1 C.B. 185.

Under the terms of Trust B, Child A's testamentary power to appoint the principal of Trust B is limited to his living children and/or the estate of any deceased child. The terms of Trust B specifically provide that the class of permissible appointees shall exclude the donee of the power, the donee's estate, the donee's creditors, and the creditors of the donee's estate. Thus, Child A will not have a general power of appointment under the terms of Trust B. Accordingly, the Trust B corpus will not be includible in Child A's gross estate under § 2041(a)(2).

Ruling 4

Section 671 provides that where it is specified in subpart E of part I of subchapter J of chapter 1 that the grantor or another person shall be treated as the owner of any portion of a trust, there shall be included in computing the taxable income and credits of that person those items of income, deduction, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual.

Section 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Section 1.671-2(e)(1) provides that for purposes of subchapter J, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

You have represented that Settlor does not have any powers over Trust or Trust A that would result in Settlor being treated as the owner of either trust and that the terms of Trust B will not cause Settlor to be treated as the owner of any portion of Trust B. Additionally, you have represented that no beneficiary has transferred or will transfer any assets to Trust B.

Based solely on the facts submitted and the representations made, we conclude as follows:

Settlor is the grantor of Trust B. Additionally, the transfer of assets from Trust A to Trust B will not cause Settlor, the trustees, or any beneficiary of Trust A or Trust B to be treated as the owner of any portion of Trust A or Trust B.

Except as specifically ruled herein, we express or imply no opinion on the federal tax consequences of the transaction under the cited provisions or under any other provisions of the Code. Specifically, we express or imply no opinion as to whether Settlor was or is an owner of Trust A or Trust B under § 675.

This ruling is directed only to the taxpayers (trustees of Trust A, trustees of Trust B, Child A, Grandchild 1, and Grandchild 2) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

George Masnik
Chief, Branch 4
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures

Copy for section 6110 purposes
Copy of this letter